

REPORT OF THE
OFFICE OF THE AUDITOR GENERAL

251

REVIEW OF REQUESTED RATE INCREASES FOR
COMMUTER SERVICES, WHICH COULD
INCREASE REVENUES BY 111 PERCENT,
SUBMITTED BY SOUTHERN PACIFIC
TRANSPORTATION COMPANY TO THE
PUBLIC UTILITIES COMMISSION

JANUARY 1975

TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

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January 30, 1975

Honorable Bob Wilson
Chairman, and Members of the
Joint Legislative Audit Committee
Room 4126, State Capitol
Sacramento, California 95814

Dear Mr. Chairman and Members:

Transmitted herewith is our report on the request for rate increases submitted to the Public Utilities Commission by the Southern Pacific Transportation Company (SP). These requested rate increases are for commute services between San Francisco and San Jose and would result in an estimated increase in revenue to SP of 111 percent for these services, or \$4.8 million annually.

We reviewed the records maintained by SP for \$6,496,002 of the \$9,247,775 expenses for 1973 included in their rate increase application. Based on our review of the \$6,496,002, we found that \$3,172,286, or approximately 49 percent of such expenses, were either inadequately supported or were incorrectly charged. The specific deficiencies noted are as follows:

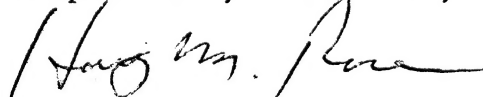
<u>Item</u>	<u>Amount</u>
Salaries which were allocated to commute operations were based on unsupported estimates of the percentage of the employees' time devoted to these operations	\$ 555,339
Expenses for repair of equipment used on passenger cars and engines were not adequately supported	486,595

Honorable Bob Wilson
Chairman, and Members of the
Joint Legislative Audit Committee
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Page 2

<u>Item</u>	<u>Amount</u>
Salaries of company executives, clerical staff and other miscellaneous employees for the systemwide operations of the Southern Pacific Transportation Company were allocated to the commute operations between San Francisco and San Jose without adequate support and, in some cases, incorrectly	\$ 643,013
Labor expenses for the repair, maintenance and service of commute locomotives were based on unsupported estimates of the time employees worked	356,824
Mechanical department expenses were based on unsubstantiated overhead rates	440,060
Employees' payroll taxes and health and welfare expenses were charged to the commute operations based on labor expenses which were inadequately supported or were incorrectly charged	315,066
Depreciation of locomotives and passenger cars that had been depreciated to their salvage value was included as an expense	<u>375,389</u>
Total deficiencies	<u>\$3,172,286</u>

While we recognize that some rate increase might be justified, we recommend that the Public Utilities Commission defer any rate increase for the commute service until SP presents a request supported by adequate and correct records.

Respectfully submitted,



Harvey M. Rose
Auditor General

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TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
FINDINGS	
The records prepared and maintained by the Southern Pacific Transportation Company in support of the company's request for a rate increase for its commute operations between San Francisco and San Jose are inadequate and, in some cases, incorrect.	2
Recommendation	9
SUMMARY OF COMMENTS OF SOUTHERN PACIFIC OFFICIALS	10

INTRODUCTION

In response to a legislative request, we have reviewed a request for rate increases submitted to the California Public Utilities Commission by the Southern Pacific Transportation Company (SP). These requested rate increases are for commute services between San Francisco and San Jose and would result in an estimated increase in revenue to SP of 111 percent, or \$4.8 million annually, for these services.

SP does not maintain a separate cost accounting system for these commute operations. The company has therefore included in its 1973 statements estimated expenses of these operations using a variety of methods. The methods used included identified direct labor charges, projections based on identified expenses for one month, and estimated percentage allocations of expenses.

The adequacy and reliability of the documentation which was available under the various methods used by the company to identify or estimate the costs of operations seriously limited the extent to which we were able to verify these expenses.

FINDINGS

THE RECORDS PREPARED AND MAINTAINED BY THE SOUTHERN PACIFIC TRANSPORTATION COMPANY IN SUPPORT OF THE COMPANY'S REQUEST FOR A RATE INCREASE FOR ITS COMMUTE OPERATIONS BETWEEN SAN FRANCISCO AND SAN JOSE ARE INADEQUATE AND, IN SOME CASES, INCORRECT.

The documentation submitted by the Southern Pacific Transportation Company (SP) with the application for a rate increase in fares for the commute services between San Francisco and San Jose included a statement of revenues and expenses for the 1973 calendar year for these operations. This statement listed revenues of \$4,289,546, expenses of \$9,247,775, and a net loss from operations of \$4,958,229.

We reviewed the records maintained by SP for \$6,496,002 of the \$9,247,775 reported expenses. The \$6,496,002 of expenses were selected on the basis of large account balances. The result of our review is as follows:

	<u>Amount</u>	<u>Percent</u>
Expenses considered reasonable and adequately supported	\$3,323,716	51%
Expenses found to be inadequately supported or incorrectly charged	<u>3,172,286</u>	<u>49</u>
Total expenses reviewed	<u>\$6,496,002</u>	<u>100%</u>

Of the reported expenses which we reviewed, 49 percent were submitted without adequate supporting documentation or were incorrectly charged to the commute operations.

While it is possible that some rate increase could be justified, based on the deficiencies noted in the \$6,496,002 which we reviewed, we estimate that an additional undetermined amount of the \$2,751,773 of expenses which we did not review are also either not adequately supported or are incorrectly charged. Discrepancies which were disclosed in our review are discussed in detail below.

Salaries of \$555,339 Which Were
Allocated to Commute Operations
Were Based on Unsupported Estimates
Of the Employees' Time Devoted
To These Operations.

A portion of the salaries of 142 SP employees, who are not charged directly to the commute operations, was allocated to the commute operations on the basis of time estimates which were prepared by two superintendents of SP. The amount of the estimated employees' time that was allocated to commute operations ranged from one percent to 85 percent. There are no records available to adequately support the reasonableness of these allocations to the commute operations.

To test the reasonableness of the allocations, we interviewed 19 of these 142 employees. Six of the employees stated the estimate appeared reasonable, five stated that none of their time was devoted to commute operations, two stated that the percentage of their earnings which was allocated to commute operations was too high, and six stated that they had no idea how much of their time was devoted to commute service operations.

Because of the lack of adequate documentation to support the allocation of these expenses, and because of the mixed responses of the individuals whose salaries were allocated, it is not possible to determine the correct amount of these salaries which are attributable to the commute operations.

Expenses of \$486,595 for Repair Of
Equipment Used on Passenger Cars And
Engines Were Not Adequately Supported.

Expenses of \$486,595 were charged to the commute operation for wages, materials and overhead for repair of equipment used on passenger cars and engines. The only supporting documentation for these charges was an intercompany memorandum and a penciled schedule showing the allocated expenses. We requested supporting evidence for these expenses and were told that no additional evidence was available.

Without supporting documentation such as invoices and payroll records to support these expenses, there is no adequate basis for such expenses to be used to justify the proposed rate increases.

\$643,013 of the Salaries of Company Executives,
Clerical Staff and Other Miscellaneous Employees
For the Systemwide Operations of the Southern
Pacific Transportation Company Were Allocated
To the Commute Operations Between San Francisco
And San Jose Without Adequate Support and, In
Some Cases, Incorrectly.

SP identified \$50,914,049 as the 1973 annual salaries for 3,671 systemwide SP company executives, general officers and assistants, professional

staff, clerks, stenographers, secretaries, typists, traveling auditors or accountants, telephone operators, messengers and office boys. These 3,671 systemwide employees of SP are located in various locations in California as well as in other states.

SP included \$643,013 of salaries for these employees as an expense of the commute operations between San Francisco and San Jose. These employees were identified as systemwide employees not directly engaged in the commute operations of SP. However, the records made available for our review did not provide adequate support that the duties performed by these 3,671 employees were of a systemwide nature and not related instead to specific operations such as freight or commute service.

Further, the records made available for our review did not provide assurance that the salaries of these employees have not also been allocated to the commute service or other operations in some other manner. In fact, in a limited test of 78 employees whose salaries had been partially charged directly to the commute operations, we found seven whose salaries were also included in the allocation of the systemwide salaries. This resulted in these salary expenses being charged twice to the commute operations.

On the basis of documentation made available for our review, it is not possible to determine the correct amount of the costs of systemwide personnel which should be allocated to the San Francisco-San Jose commute operations.

Labor Expenses Totaling \$356,824 for The
Repair, Maintenance and Service of Commute
Locomotives Were Based on Unsupported
Estimates of the Time Employees Worked.

In order to determine labor expenses for repairing, maintaining and servicing diesel locomotives used on freight trains and on commute trains, SP foremen made arbitrary estimates of the portion of time employees worked on these locomotives. Using these estimates, labor expenses of \$356,824 were developed for the repair, maintenance and service of diesel locomotives used on commute operations.

These labor expenses are not substantiated through payroll or other cost accounting records. Specific employees cannot be identified with the estimated hours allocated to the commute operations and the accuracy of these expenses cannot be determined.

Mechanical Department Expenses of \$440,060
Were Based on Unsubstantiated Overhead Rates.

SP labor charges for its mechanical department are increased by two overhead percentage rates. The two rates are, according to SP officials, designed to charge the commute operations for the salaries of foremen and other mechanical department expenses that are not charged directly. The charges were determined to be \$440,060 for the year 1973.

While we do not take exception to the method followed, SP could not provide us with documentation supporting the percentages used for 1973. SP informed us that the rates had been in effect a number of years and the documentation substantiating the percentages used was no longer available.

During our review, in an attempt to justify the overhead percentages used in 1973, SP officials made limited studies of 1974 data which indicated to them that one of the rates used for 1973 was too high and that one was too low. No changes have been made to the data submitted to the Public Utilities Commission, however.

Inasmuch as SP could not provide us with adequate documentation to support the overhead percentage rates used for 1973, we were unable to determine the reasonableness of these overhead charges.

\$315,066 of Employees' Payroll Taxes And
Health and Welfare Expenses Was Charged
To the Commute Operations Based on Labor
Expenses Which Were Inadequately Supported
Or Incorrectly Charged.

SP has included \$315,066 for employees' payroll taxes and health and welfare expenses on labor expenses which we have discussed in previous sections of this report as being inadequately supported or incorrectly charged.

To the extent that the labor expenses are not adequately supported, the related payroll taxes and health and welfare expenses are also incorrect and should not be included as an expense of the commute operations.

Depreciation of \$375,389 on Locomotives And
Passenger Cars That Had Been Depreciated To
Their Salvage Value Was Included as an Expense.

SP reported \$346,697 and \$28,692 as depreciation expense for locomotives and passenger cars, respectively, in its 1973 statements of commute

operations expenses. However, these locomotives and passenger cars had been depreciated to salvage value, and therefore depreciation should not have been claimed for these assets.

SP officials stated that the Interstate Commerce Commission requires SP to include depreciation charges for all equipment that is still in use, even though such equipment has been depreciated to salvage value.

Along with its statement of 1973 revenues and expenses, SP provided the Public Utilities Commission with adjusted statements which did not include this item of depreciation. However, the statement showing a reported loss from operations of \$4,958,229 in 1973 was not footnoted to show that this \$375,389 for depreciation was not actually incurred.

CONCLUSION

The expenses submitted by the Southern Pacific Transportation Company in support of its request for rate increases, which would result in a 111 percent increase in revenues for commute operations between San Francisco and San Jose, were inadequately supported and, in some cases, incorrectly charged. While we recognize that some rate increase might be justified, the magnitude of the amounts disclosed by our review as inadequately supported or incorrectly charged indicate that a rate increase should not be granted now on the basis of the documentation which has been submitted by SP.

In our judgment, adequate support for allocation of expenses to SP's commute operations could be developed basically from existing company data and basically with existing accounting and data processing equipment without the expenditure of significant additional funds.

RECOMMENDATION

We recommend that the Public Utilities Commission defer any rate increases for the commute services operated by the Southern Pacific Transportation Company between San Francisco and San Jose until the company presents a request supported by adequate and correct records.

SUMMARY OF COMMENTS OF
SOUTHERN PACIFIC OFFICIALS

1. "It is Southern Pacific's position that, after discussion with the representatives of the State Auditor General's office, the principal point of difference is in the necessity of support for expense allocations.

"Southern Pacific maintains there were few inaccuracies or errors in the compilation of the costs, and that the impact of the necessary corrections would be inconsequential.

"In so far as the allocation procedures are concerned, it is Southern Pacific's judgment that the use of supervisory experience to allocate certain expense items is the most cost-effective method by which the commute expenses can be identified. In order to comply with the Auditors' position on total verification of the allocation procedures, it would be necessary for the company to spend substantial additional sums of money. The cost of this much more elaborate system would necessarily be a proper expense chargeable to the commute operations."

2. SP maintains its accounting records in accordance with the "Uniform System of Accounts for Railroad Companies Prescribed by the Interstate Commerce Commission, Issue of 1968, as Revised to October 1, 1973". SP also has regular audits by the Interstate Commerce Commission and by its public accountants, Haskins & Sells.

3. The SP officials believe it is inappropriate for the Auditor General to make a recommendation to the Public Utilities Commission to not grant SP a rate increase.